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BEFORE THE ARIZONA CORPORATION COMMISSION
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2007 JAN 29 A 11: 34

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IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY,
AN ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT FAIR
VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN ITS
RATES AND CHARGES BASED THEREON
FOR UTILITY SERVICE BY ITS MOHAVE
WATER AND WASTEWATER DISTRICTS.

Docket No. WS-01303A-06-0014

Arizona Corporation Commission

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RUCO'S REPLY BRIEF

The Residential Utility Consumer Office ("RUCO") replies to Arizona American Water Company's ("Arizona American" or "Company") and the Arizona Corporation Commission Staff's ("Staff") Post Hearing Briefs as follows.

PROPERTY TAXES

The Company is critical of RUCO's property tax position noting that it has been repeatedly rejected by the Commission. Initial Brief of Arizona-American Water Company ("Company Brief") at 13. The Company relies on Decision No. 68858 where the Commission determined – "RUCO has not demonstrated a basis for departure from our prior determination on this issue." Company Brief at 13.

1 RUCO acknowledges that the Commission has rejected ADOR's methodology in the
2 past. See RUCO Brief at 7. The fact that it has been rejected does not equate to the
3 conclusion that it is an inferior methodology for estimating property taxes than what the
4 Company is proposing. Nonetheless, RUCO has demonstrated in this case that the
5 Commission should depart from its varying prior determinations on this issue. RUCO's
6 property tax study compared the Company and ADOR methodologies to the actual tax bills of
7 ten different water systems that have applied to the Commission for rate increases since the
8 ADOR memorandum was released. RUCO-6 at 20-21. Both methodologies resulted in over-
9 estimates of property tax expense, but the ADOR methodology was substantially more
10 accurate. RUCO-4 Final Revised Surrebuttal Testimony Exhibit at page 5.

11 The issue of property tax is not a question of who is right and who is wrong. The issue
12 is what calculation methodology provides the best estimate of actual property tax. Enough
13 time has passed since ADOR issued its memorandum that the Commission can look at the
14 data objectively and make that determination. RUCO has not selectively chosen companies
15 or taken other action that would skew the results in favor of the ADOR methodology. The
16 results of RUCO's study shows that the ADOR Methodology has an estimation error of 1.6%
17 compared to the Company's methodology, which had an estimation error of 13.8%. RUCO-4
18 Final Revised Surrebuttal Testimony Exhibit at page 5. The Commission should reject the
19 Company's methodology.

20 The Company dismisses RUCO's study, claiming it is flawed in three ways. Company
21 Brief at 13-14. First, the Company claims that RUCO's study fails to include taxes on
22 individually assessed parcels in amounts actually paid to ADOR. Id. Second, the Company
23 claims RUCO's study is misleading because it assumes that new rates in each of the cases
24 cited went into effect well before they actually did. Company Brief at 13. The Company's

1 observations miss the point of RUCO's study and demonstrate the Company's lack of
2 understanding of RUCO's study. The intent of the study was never to gather information of
3 different companies' earnings (i.e. amounts actually collected or paid to ADOR). Transcript at
4 288 and 292. The intent of the study was simply to apply the two methodologies (ADOR and
5 Company's methodologies) using each methodology's respective revenue inputs to 10
6 different companies and to compare the differences between the resulting estimates and the
7 actual tax bills of the different companies. Id. RUCO's study started with the test year for
8 each company, and it is not a concern whether the rates had gone into effect yet. Id. Nor is it
9 a concern that there is a lag between the test year and when the rates actually went into effect
10 and the Company starts collecting the revenues. Id. The purpose of this study is to compare
11 the accuracy of the two methodologies in estimating actual property tax assessments.

12 Whether new rates were in effect in any given year or not is not relevant to the study.
13 RUCO's study simply compares the two methodologies to what ADOR actually assessed in
14 order to allow the Commission to see first hand which methodology provided the more
15 accurate estimate of property tax expense. The Commission should disregard the Company's
16 argument.

17 Finally, the Company impugns RUCO's study because RUCO's witness, Timothy
18 Coley, has not explained how he chose his sample or why he decided to exclude available
19 data for additional water/wastewater systems. Company Brief at 14. Mr. Coley testified that
20 he tried to pick a representative sample of stable and growth oriented water companies in his
21 study. Transcript at 259. Mr. Coley included in his sample two Arizona-American districts –
22 Aqua Fria and Tubac. Id. at 258. Mr. Coley excluded from his sample companies that
23 appeared unstable or had other strange phenomenon associated with it. Id. For example, Mr.
24 Coley excluded the Company's Sun City Water District, which had a wide range of tax rates

1 associated with it over the five-year period since the ADOR memorandum was issued. Id.
2 Again, RUCO was not looking to skew the results or use data that only supports RUCO's
3 position. In fact, RUCO's study shows that 50% of the companies in its study over collected
4 under the ADOR methodology. RUCO-4 at 1-6. RUCO's study presents a fair, unbiased and
5 reasonable representation of Arizona's water utilities and should be given great weight.

6 RUCO addressed the reasons why it excluded other Company-specific data as well as
7 the Company's study in its Initial Brief. RUCO Brief at 6-7. The Commission should adopt a
8 methodology that provides the best estimate of property taxes. RUCO has shown
9 conclusively that the ADOR methodology results in the best estimate of future property taxes.
10 RUCO, however, in the spirit of compromise, suggests the Commission consider a property
11 tax calculation that uses two historical gross revenues and one year of projected revenues.
12 Transcript at 298.

14 **WORKING CAPITAL**

15 The Company's position that the Commission should include "equity expense" in its
16 working capital calculation is based on a quid pro quo argument – The Commission should
17 not include interest expense in working capital (as RUCO proposes) unless it also includes
18 equity expense. Company Brief at 11. The Company's argument simply ignores the
19 accounting principle behind the Company's cash working capital requirement and provides no
20 accepted accounting basis for including the costs associated with its equity.

21 Working capital concerns the capital that is necessary for the Company to operate its
22 business. The return on the Company's equity is unrelated to the Company's operating costs,
23 and accordingly does not create any working capital requirement. See RUCO's Brief at 9.

1 There is no accounting basis in support of the Company's position. The Company's equity
2 argument that "RUCO cannot have it both ways" is a red herring and should be rejected.

4 **RATE CASE EXPENSE¹**

5 The Company maintains that rate case expense should be allocated based on each
6 district's share of test year adjusted revenues. Company Brief at 16. The result in this case
7 would be that the Company's water customers would subsidize its wastewater customers for
8 its rate case expense. According to the Company, the Company's proposal (as well as
9 Staff's) "...is much fairer to wastewater customers." Id.

10 RUCO is persuaded that under the Company's and Staff's proposal, wastewater
11 customers would be happier. People tend to be happy when they get a free lunch.
12 Unfortunately, water customers would be getting the short end of the stick. RUCO's
13 recommendation apportions rate case expense based on the estimated time that was spent
14 on each district. RUCO-5 at 54. Under RUCO's proposal, ratepayers pay their portion of rate
15 case expense. It is the only fair choice for everyone.

17 **DEFERRED TAX ASSETS**

18 The Company claims that all it is doing with its proposed Deferred Tax adjustment is
19 trying to put the Company back in the position it would have been had there never been an
20 acquisition premium. Company Brief at 10. The Company believes that its position would not
21 be so "vexing" to RUCO had it not asked for recovery of a portion of the acquisition premium
22 in the first place. Id. The Company misses the point.

24 ¹ RUCO addressed the individual rate case expense items raised in the Company's Brief in RUCO's Brief and has nothing further to add. RUCO's Brief at 11.

1 RUCO did not object to the Company's restated deferred tax schedule which included
2 deferred tax liabilities for the water and wastewater divisions. A-16 at 7-8. At the time the
3 Company proposed its restated adjustments, the time for discovery had passed. Transcript at
4 309. RUCO was unable to verify the adjustments, but did not object because the adjustments
5 made sense. In other words, RUCO was not perplexed by the notion that the Company would
6 seek a deferred tax adjustment to place it in the same position it was before the acquisition
7 premium was incurred.

8 RUCO's concern developed after the Company restated its deferred tax liability to a
9 deferred tax asset at the hearing. This restatement makes no sense. It is seldom that a
10 utility's deferred tax assets exceed its deferred tax liabilities because utilities are typically plant
11 and capital intensive. Transcript at 309-310. The Company offers no support to show the
12 basis for a deferred tax asset. The burden is on the Company to substantiate its adjustments.
13 *In the Matter of the Application of Southwest Gas Corporation for Establishment of Just and*
14 *Reasonable Rates, Decision No. 68487* at 21. While the Company's Brief sets forth a
15 numerical calculation that purports to demonstrate the appropriateness of its proposed
16 deferred tax adjustment, the example merely demonstrates that the Company has deferred
17 taxes related to rate base assets and liabilities and to non-rate base assets and liabilities (i.e.
18 the acquisition premium). It does nothing to address RUCO and the Staff's concerns that the
19 Company's removal of the non-rate base deferred taxes has the effect of creating a net
20 deferral tax asset where, prior to the removal, there had been a net deferred tax liability. The
21 Company's deferred tax adjustments should be rejected.

1 **CUSTOMER GROWTH ANNUALIZATION**

2 There is a discrepancy between the Company's and RUCO's proposed residential bill
3 counts. The Company proposes a residential bill count of 155,894 and RUCO proposes
4 160,749. Company Brief at 14. The Company claims RUCO's proposed residential bill
5 counts should be discarded because RUCO has not explained the difference for the
6 discrepancy. Id.

7 The Company overlooked RUCO witness Timothy Coley's testimony on this issue. Mr.
8 Coley testified that the Company, unlike RUCO, made an adjustment to increase revenues to
9 reflect the average number of customers. RUCO-5 at 35-36. RUCO based its revenue
10 annualization on the test year end number of customers. Id. This explains the difference in
11 the proposed bill counts. In Arizona, the Commission requires the use of a test year rate
12 base. It is therefore necessary to match the level of net investment reflected in rate base with
13 the level of revenue that investment will generate. Id. Proper ratemaking requires matching
14 the test year end customer count with the test year end rate base. Id. The use of an average
15 bill count will understate the level of revenues and expenses on a going forward basis. Id.
16 The Commission should approve RUCO's proposed residential bill count.

17
18 **COST OF CAPITAL**

19 RUCO continues to urge the Commission to adopt RUCO's recommended 9.10 percent
20 return on common equity and overall 7.07 rate of return for Mohave Water and Wastewater.

21
22 **RATE DESIGN**

23 The Company claims its rate design represents a gradual approach to the
24 implementation of significant rate increases. Company Brief at 34. The Company implies that

1 RUCO does not understand the principle of gradualism and its rate design unfairly shifts more
2 of the increased burden to large users. Id.

3 The Company, however, discounts the Commission's goal of promoting conservation
4 with its rate design. Instead, the Company has exaggerated the burden the Commission's
5 normal practice of recovering revenues based on a 60% commodity/40% minimum charge
6 ratio will have on large users. There are times when the 60%/40% ratio would be
7 inappropriate. For example, in the Company's Paradise Valley Water District case, water use
8 was so high that recovering 40% of service costs through the monthly minimum would have
9 resulted in an abnormally high minimum charge. RUCO-6 at 31. The same concern is not
10 present here. The Company has not provided a reason why a 60%/40% ratio would be
11 inappropriate in this case.

12 Recovering a greater percentage of cost from high-end users is exactly the message
13 the Commission should be sending in order to promote conservation. It encourages high-end
14 users to reduce their consumption. Reducing that cost percentage will have the opposite
15 effect -- it will encourage consumption. Encouraging conservation is exactly what the
16 Commission is trying to accomplish. The Commission should adopt a 60%/40%
17 commodity/monthly minimum charge ratio in this case.

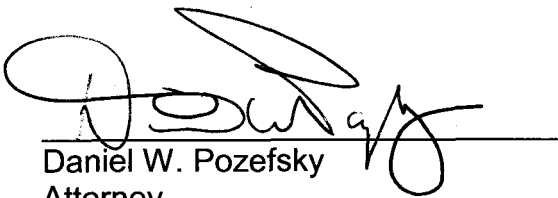
18 19 **CONCLUSION**

20 The Commission should authorize a rate increase of not more than \$280,860 for the
21 Company's water and \$105,239 for the Company's wastewater districts. The Commission
22 should not ignore the empirical evidence presented in this case on the issue of property tax,
23 and should adopt the ADOR Methodology as it is the best estimate of future property tax
24 expense. The Commission should also reject the Company's recommendation to include the

1 cost of its equity in its working capital requirement. Rather, the Commission should include
2 the Company's interest expense in working capital as it is a cash item. The Commission
3 should not approve the discriminatory apportionment of rate case expense, but should instead
4 allocate rate case expense between the systems based on the amount of work expended per
5 system.

6 The Commission should reject the Company's late attempt to reclassify its deferred tax
7 recommendation as an asset. The Commission should approve RUCO's proposed residential
8 bill count. The Commission should adopt RUCO's recommended rate of return of 7.07
9 percent. Finally, the Commission should approve RUCO's recommended rate design.

10 RESPECTFULLY SUBMITTED this 29th day of January 2007

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12 
13 Daniel W. Pozefsky
14 Attorney

15 AN ORIGINAL AND THIRTEEN COPIES
16 of the foregoing filed this 29th day
17 of January 2007 with:

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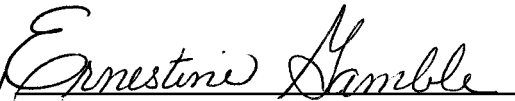
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